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Economic Conditions
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General Business Conditions

THE hope expressed so widely a month ago, that February would bring a pronounced turn toward industrial peace, order and production, has been realized only to a limited extent, and with the stock market breaking badly feelings of disappointment and uncertainty again seem to be uppermost. The steel strike has been settled and a threatened paralysis of industry for lack of steel averted, but the settlement is on terms which put fresh upward pressure on wages and prices generally. A mass of wage and price adjustments must follow, not only in steel fabricating and consuming industries but in others, and these adjustments will not be made easily or quickly because the approval of government agencies will be required at every step. Meanwhile the electrical workers strike and the General Motors strike have continued, and there are new strikes and threats of strikes daily.

The optimistic view of the situation is that this is the last wave of the industrial conflicts; that with the establishment of the "new wage-price policy" by order of President Truman, February 14, a pattern has now been worked out for their settlement; and that out of the present turmoil will soon come a new balance of wages, costs and prices upon which the industries can get to work. The whole country hopes this view will prove correct. However, it is not one that will be realized automatically, but only by appropriate government policies and all-around cooperation.

In his radio address October 30, 1945, President Truman wisely emphasized that no general formula for increasing wages can safely be applied because conditions differ between industries and companies. But in recent weeks a formula, in effect, has been established by events. It was set by the President's decision that 18½ cents an hour was a fair increase for the steel workers, by the report of the fact-finding board recommending 19½ cents in the General Motors case, by increases of around 18 or 18½ cents granted by a number of large companies, and more recently by the decision to give the packing house workers 16 cents. Now the National Wage Stabilization Board has been directed to approve any increase "consistent with the general pattern of wage or salary adjustments which has been established in the industry or local labor market area."

All this results in a pattern of increases centering around 18 to 18½ cents an hour or 15 to 20 per cent. The increases go around the circle. They are large increases, even for companies of superior efficiency and financial strength. It is hardly to be expected that friction can be avoided as the unions make equivalent demands on smaller and weaker companies. Employers who thought their wage problems had been settled by increases granted earlier, but at figures below the now-established pattern, may find their difficulties cropping up again. Other major wage negotiations are to come, notably in the coal industry this month.

Price Adjustments Permitted

The principal feature of the new wage-price policy is that the inevitability of price increases and the need of prompt adjustments are recognized. The previous policy, that adjustment of price ceilings in hardship cases created by wage increases should be deferred six months, is dropped; and the Price Administrator is directed to provide promptly for such adjustments, in the case of approved wage increases.

The new order is welcome but manufacturers are far from reassured. Their first thought is that the flood of wage increases will lead to a flood of price relief applications. Each application will have to be, first, approved as to the wage increase by the Wage Stabilization Board and, second, acted on by the Office of Price Administration. The Wage Board has set up procedures to give pre-approval and blanket approval to wage increases, and both agencies may be expected to do their best to clear applications promptly. Yet the burden on them will be tremendous

and delays can be harassing and destructive. The OPA will give no prior assurances of price relief to manufacturers considering wage increases, which is an obstacle to settlement of strikes.

In the second place, the formulas of the OPA are rigid, and the public statements of its officials indicate that its dominant policy is to "hold the line". The definition of "hardship cases" is a severe one. An industry is considered to be in hardship only if, after wage increases, ceiling prices leave its earnings insufficient in the judgment of the Price Administrator to yield during the next twelve months an average rate of return on net worth equal to that earned in 1936-39. This allowable return is calculated before taxes, although the corporate tax rate in 1946 is 38 per cent, against only 17 per cent on the average in 1936-39. In the main OPA will deal with price questions with each industry as a whole; it will not give individual company cases priority whenever the overall method can be followed.

In this combination of rigid and severe formulas, the declared intention to hold the line, and possible swamping of OPA's staff, manufacturers see difficulties and uncertainties ahead. The provision that the agency's judgment as to conditions over the next twelve months shall be controlling means that estimates of sales volume, materials prices and productive efficiency will enter into the OPA decisions. But while OPA makes the decisions, manufacturers will have to bear the risks.

As against these uncertainties, it should be noted that OPA has yielded to the necessities of the steel situation by granting a $5 per ton increase in prices. It is establishing higher ceilings on cotton goods which partially offset the rise in raw cotton and other costs, and it is raising meat prices to help the packers pay the higher wages recommended by the fact-finding board. In many other cases it will have no choice but to acquiesce in higher prices or see production restricted.

OPA and Inflation

Most people in this country know that price policy is of profound concern to everyone, but many seem not to know whether they should favor more realistic and liberal pricing because of the difficulties and uncertainties of manufacturers, or oppose it because of the higher prices resulting. Controversy over bulges in the price line has developed rapidly during the past month. Increases are denounced on the ground that they are "appeasement of business", or that they undermine the anti-inflation program. Telegrams are sent to the President and Congress calling on them to defeat the "business-minded" men in the Government.

Presumably these views are urged out of a sincere desire to protect the country from the inequities and hazards which everyone agrees are created by an inflationary rise in prices. Unfortunately, however, many of the people who now would try to suppress the consequences of inflation in a manner which would prevent industrial recovery have approved or condoned the measures and policies which have produced these consequences. The time for concern about advancing prices was when the policies and measures leading to the higher prices were put into effect.

In many publications, including this Monthly Letter, in many public pronouncements and by many people, the danger of inflation has been described and warned against since the beginning of the war. We have pointed out the inflationary nature of various steps taken and policies followed since V-J day, and have sought to prepare our readers for their consequences. Once these inflationary forces are set in motion, and begin to have their effect in higher industrial costs, it is idle to think that their consequences can be averted and the country escape scot-free by sitting tightly on prices. Costs have been raised by wage increases. Unless prices cover costs and furnish an inducement to production the industrial organization will not pull itself out of its disorder, goods will continue scarce, and employment will suffer. The disruption of production and employment is the one thing that the country cannot afford.

Causes of Price Advances

The primary inflationary force is of course the wartime expansion of the money supply relative to the supply of goods for civilian use. This expansion is a result of the war financing. It has occurred in all major wars here and in other countries, and while there are differences of opinion as to whether it could have been held within narrower limits, to a great extent it was unavoidable. This expanded money supply, particularly when supplemented by the policy of constantly lowering interest rates, has exerted inflationary pressures in many directions. In all markets its presence has been equivalent to that of a piece of tinder waiting for the spark to start the flame.

It has always been possible, however, assuming sound policies, understanding, effort and unity, to limit or neutralize the influence of the expansion of the money supply, — first, by achieving a rapid and great expansion of production of civilian goods to counter-balance it; second, by cooperation in maintaining cost and price stability; and, third, by restraint in spending. The present and prospective price increases, or alternatively the industrial disorder, are the consequences of failure in all these respects.

For two or three months after V-J day the prospect for rapid reconversion of the war industries, and for early volume production of needed civilian goods, was bright beyond all expectations. The problems of plant clearance and changeover and of settlement of war contracts were handled more effectively than most people believed possible. Unemployment never appeared in the predicted volume. There was reason to think that the automobile industry and the consumer durable goods industries in general would be under strong momentum by the turn of the year and moving toward full production by Spring. The Federal Reserve index of industrial output showed signs of making its bottom around 160 (1935-39 = 100).

A Bright Prospect Blighted

Meanwhile, however, the conditions which have led both to curtailment of production and to increases in costs were developing. Mistaken fears of deflation and depression led the Government to support demands for large wage increases and other measures "to maintain purchasing power". This support was expressed publicly by high officials and even more concretely by memoranda from government departments "demonstrating" that large wage increases could be paid without advancing prices. Union demands have been strengthened, disturbances have followed, and they have fallen with blighting force on the bright reconversion prospect. Production has been stopped in many plants and wage costs have been increased in virtually all. Applications for price relief in many cases have met with indifferent success either as to the relief obtained or the promptness with which it was granted. Low man-hour output was another consequence of the unsettlement. The Federal Reserve Board's index for February cannot yet be calculated but it has undoubtedly dropped much below the 160 level above mentioned.

The argument that the wage demands could be met without advancing prices was supported by calculations based on overall or average figures. The errors in reasoning were numerous. But the greatest error was the failure to understand that economic influences do not operate, nor does economic change occur, at the level of the average producer but rather at the margin. Always it is the marginal producer who bears the chief burden of adjustments. Even if the calculations as to the average ability to absorb higher wage costs had been correct, the important matter would still have been whether the above-average, high-cost or marginal producer could absorb them. If he could not, his production would become unprofitable and soon be lost to the markets.

The practical test of the wage increases is now going on. It is seen that in some industries, including steel, cotton goods and meat packing, overall price increases have had to be authorized. Evidently increases will be necessary in other cases. As the issue comes to a head, those who are denouncing producers for seeking and the OPA for permitting a bulge in the price line might well ask themselves two questions. Where is the primary responsibility for the inflationary trend to be found? Second, who can contribute more to economic welfare under these conditions,—the manufacturer who seeks cost-price relationships which will permit him to produce at capacity, or an agency which, however excellent its motives, would perpetuate cost-price conditions making production unattractive and unprofitable and thus shutting it off?

Views of the A.F. of L.

Opinions expressed by the American Federation of Labor in its January Survey were referred to in this Letter last month. In its February Survey, the A. F. of L. returns to the subject. It states that A. F. of L. unions "won outstanding wage gains through collective bargaining," but that "none of our gains caused any increases in prices . . . because employers and workers had considered the facts and agreed on increases which would not break price ceilings." Unions outside the Federation, it says, "had other methods. Simultaneous strikes in basic industries, with uncompromising demands, were designed to force government intervention." Under this method, continues the article:

> The Government is brought between management and labor to dictate a wage formula. A substantial increase is awarded. The price ceiling is broken. Workers' living costs go up. It is estimated that the rise in living costs this year will be from 8 to 10 cents on the dollar. So workers pay back part of their wage increase.
>
> Most American workers are too intelligent to let themselves be fooled. They know that wage increases have to be paid out of the earnings of the business, or else by a price increase. Tactics which force Government intervention and raise living costs bring a loss in the long run.

The Outlook

Turning in conclusion to the business outlook, the unfavorable developments are seen to have been of two kinds. First, weeks and months have been lost, reconversion has been delayed, enterprise has been shocked, the supply of goods has not increased as it should have done, and inflation has gained a stronger foothold. Second, wage, cost and price relationships have been disturbed, and the economic organization cannot be expected to function at full speed until a new balance is achieved.

The strong points in the outlook of course are plain. The demand for goods and materials is huge and urgent and no satiation is in sight. In almost every industry manufacturers can sell everything they can produce and see a market ahead that in most cases cannot be filled for a long time. The amount of work needed in construction and in turning out durable goods generally is probably greater than the country has ever known. The whole world wants American goods. There is probably no instance in history where a depression has occurred under the conditions now prevailing, and it can hardly be doubted that a great volume of business and high employment will be reached as soon as all elements of the economic organization begin to work together.

One question is *when* workable cost-price relations and industrial peace will be restored. A second is whether the best to be expected is a temporary "replacement boom" — perhaps narrowed and shortened by impediments to enterprise — or whether a sound and secure basis can be built for lasting prosperity, which requires balance not only between industrial costs and prices, but between prices of all kinds. The tragedy of inflation is that it destroys that balance, for all prices and incomes do not go up together, and in the end the rise is stopped and the trend reversed because people whose incomes lag become unable to buy the products of those whose demands push up prices.

High volumes will help business bear high costs. Yet for the long run this cuts both ways. Cost-price relationships which are practicable only in times of capacity or near-capacity operation cannot be borne when demand falls off. The Wall Street Journal of February 26 published a survey of the effects of the steel wage increase and price advance on the earning power of the U. S. Steel Corporation, from which it estimated that the "break-even point" or operating level necessary to show a profit had risen to 75 per cent of capacity. This is tantamount to saying that one of the premier industrial corporations of the country can earn a return for its shareholders only in exceptionally good times. Production in the years just before the war averaged around 60 per cent.

A situation where a minority group of the population forces up prices of products sold to other groups, and in which even the higher prices are supportable only while everything is working at high speed, is a precarious basis for lasting prosperity. The way to strengthen it, to which all aims should be directed, is to increase efficiency, expand man-hour output, and whittle away at present inflated unit costs.

"From a 'Bewildered Small Business Man'"

In the New York newspapers last month appeared a full page advertisement under the above heading, signed by the president of a small manufacturing concern, reading in part as follows:

> **Unless we have a good income and a good wage we cannot spend. If we do not purchase, industry has nothing to sell. Every man or woman who works, saves a little money and spends the rest. This spending for whatever they require in the way of material things is what makes prosperity. These things that they buy must be manufactured at a profit because unless industry has a profit it does not exist and if it does not exist there is no employment.**
>
> **It might be argued that the last depression was caused by overproduction. That is not true. It was caused by the inability of labor (the entire American Public) to purchase that which industry manufactured because the wages of labor were not sufficiently high. In other words, couple well-paid labor with extensive production and you will never have a depression.**
>
> **. . . I sincerely and wholeheartedly believe that only by good honest work, by producing the things that we all need, at prices we can pay, will we lick our present difficulties.**

This statement is noteworthy, not alone for its arresting heading, which will evoke sympathy, but because it indicates how people are thinking on current economic questions. The sponsor of the advertisement, who frankly confesses himself "bewildered", presents a statement containing a great deal of sound sense. Involved also, however, is a rather common economic fallacy resulting in inconsistencies and contradictions shared unhappily by many others.

Glancing through the above quotation, one detects as the main text the assertion that "the last depression . . . was caused by the inability of labor (the entire American Public) to purchase that which industry manufactured because the wages of labor were not sufficiently high."

This has a familiar ring. It is a form of the old "purchasing power" argument, now reappearing in the contention that unless take-home wages are maintained at the wartime peak, deflation of purchasing power and depression will surely follow. Quite apart from the question as to how well this advertiser remembers the conditions of the late '20s — the booming wages and payrolls, speculation, and lavish spending not only of current income but of future income mortgaged through instalment credit — how much merit is there in the theory itself?

How, for example, would he determine when wages and incomes are not high enough, and by what margin; and assuming he could so determine, how would he go about raising, by the proper amount, the incomes of everyone — the farmer, the wage earner, the white collar

worker, the tradesman, the teacher, the pensioner, etc.? What good would it do to raise everyone's income if the effect is merely an all around increase in prices? And what good would it do to raise some groups and not others, if the effect upon production costs and prices is such that the gain in purchasing power of the more fortunate and strongly organized groups is at the expense of the purchasing power of those less fortunate and less able to protect their interests?

Further— it should be clear on reflection that the thesis that the American people were thrown into depression because their wages (incomes) were not high enough to absorb their own output is one that will not hold water. Since the purchasing power of each individual is in the value of goods and services exchanged with others, the purchasing power of the people as a whole must of necessity equal the total value of the goods and services offered in the exchanges. Any idea of inequality, such as the statement suggests, is fallacious.

The truth is that there is much more to the secret of prosperity than the amount of wages and incomes received in the community. A great deal depends upon what people want to do with their money — how much they want to spend and how much they want to save. It depends upon the willingness to venture and put savings to work in starting new enterprises that satisfy needs and provide employment. It depends upon producing the kinds of things people want, in the right amounts, and at the right prices so that the markets will clear themselves. Henry Hazlitt put the case well when he said in the New York Times of September 24, last:

> As to the prices, wages, and profits that should determine the distribution of the product, the best prices are not the highest prices, but the prices that encourage the largest volume of sales. The best wage rates for labor are not the highest wage rates, but the wage rates that permit full production, full employment, and the largest sustained payrolls. The best profits, from the standpoint not only of industry but of labor, are not the lowest profits, but the profits that encourage most people to become employers or to provide more employment.

Mr. "Bewildered Small Business Man" seems to have an appreciation of all this when he speaks of the need for making a profit, and for producing "the things that we all need" and "at prices we can pay."

What he apparently does not see so clearly is that one cannot in one breath logically maintain that wages and incomes are everything, and in the next declare "sincerely and wholeheartedly" the belief "that *only* (italics ours) by good honest work, by producing the things that we all need, at prices we can pay, will we lick our present difficulties."

For if wages and incomes are the all-important consideration, then obviously these other things are not. If, on the other hand, these others are the "only" things that count, then wages and incomes are not the determinants. To declare that either of these two alternatives offers the only condition of prosperity, without any ifs and buts, not only over-simplifies the problem but is essentially a contradiction.

Money and Banking

The money market has had plenty of food for thought during the past month, and the feeling has grown among careful students of credit that the time is ripe for a reappraisal of the situation and outlook. This feeling is prompted by a number of things that have happened since the close of the Victory Loan in December, to wit:

1. The outburst of speculative and panicky buying of government securities in January and the early part of February that carried the new 22-27 year Victory Loan 2½s from their issue price of par to a peak of 105⅛, at which the yield was less than 2¼ per cent.

2. The recent statements by Federal Reserve officials indicating concern over inflationary pressures developing from the decline in interest rates and from the absorption of government securities by the banking system.

3. The conferences in Washington in January between Treasury and Federal Reserve officials, and between the Treasury and representatives of life insurance companies and commercial banks, on questions of postwar credit and fiscal policy.

4. Disclosure in the budget message of the Government's intention to draw on its large cash balances built up by the Victory Loan to retire $7 billion of outstanding federal debt by June 30, 1947; and announcement by the Treasury of the decision to retire $2.8 billion of debt in March this year, as a first step in this program.

The soaring government bond quotations, and break in yields, following the Victory Loan were reflections of (1) the prospect that, with the large oversubscription of the Victory Loan and the approach to a balanced budget, there might be no more offerings of Treasury securities for new money, and (2) the widely held belief that the Treasury wanted still cheaper money and would delay long-term refinancing until it could be done at substantially lower rates. Not only was the market generally convinced that medium- and long-term rates were headed downward, but there was considerable apprehension also that the ⅞ per cent rate on 1-year Treasury certificates might be reduced.

By the latter part of January the warning statements by Federal Reserve officials and initiation of the Treasury conferences mentioned above were recognized as introducing new possibilities into the situation. Pending conclusion of these conferences the market largely marked time, but experienced a new burst of strength when unofficial reports were generally interpreted as indicating no significant change in the low interest policy.

Following this spurt, however, and in the absence of any authoritative delineation of official policy, the market quieted down and prices moved more narrowly. With the Federal Reserve continuing to urge measures for curbing credit expansion, including elimination of the Federal's ½ of 1 per cent preferential discount rate on short "governments" and making the regular 1 per cent rate the effective rate, investors have been less inclined to rush out and buy on the theory that prices could move only in one direction. Moreover, the very rapidity of the recent advances increases the market's vulnerability to any sudden shock.

The offering by the Treasury of ⅞ per cent certificates in exchange for $3,147 million of the $4,147 million Treasury certificates maturing March 1 has tended to reassure the market a to the stability of the certificate rate. At the same time the decision to proceed rapidly with debt retirement, as evidenced by the intention to retire with cash not only $1 billion of the March 1 certificates, but also $1,291 million of 1 per cent notes and $489 million of 3¾ per cent bonds called for payment March 15, will be an additional market factor. On June 15, $1,036 million of 3s and $819 million of 3⅛s have been called for payment, and while the Treasury has made no statement as to how these redemptions will be handled it is generally anticipated that they will be met in cash, with the possibility also that some maturing certificate issues will be handled in the same way.

Debt Reduction and the Banks

To the extent that securities paid off in cash are held by the Federal Reserve Banks and by private holders other than commercial banks, the effect of the operation is to reduce bank excess reserves — in the first case by absorbing funds into the Reserve Banks, and in the second, by converting war loan deposits into ordinary deposits with consequent increase in required reserves.

To the extent, on the other hand, that redeemed Treasury securities are held by the commercial banks their payments will not mean any reduction in excess reserves for the commercial banking system as a whole, but both war loan deposits and earning assets will decline, and individual banks may experience pressure upon their reserve positions, while others gain excess reserves, as funds are shifted about.

Of the $2.8 billion of "governments" to be redeemed this month, the largest share apparently will fall in the category of commercial bank holdings. According to latest available Treasury data (Oct. 31) about $1.8 billion of these securities were held by commercial banks, $350 million by the Reserve Banks and government agencies, and $650 million by other nonbanking holders. Since then there has doubtless been considerable shifting, with probablity of further concentration into the commercial banks and Reserve Banks.

With earning assets cut down, the question arises as to how far banks may be tempted to try to offset the decline in earnings by extending their purchases of medium-term securities, with consequent decrease of liquidity and lengthening of the average maturity of their bond portfolios. Now that the war is over and bank assets are no longer expanding, and in view of the likelihood of important regional shifts in funds and of renewed demands for commercial loans, many banks will want to follow the policy of maintaining their liquidity by reinvesting in short-term securities or even by reducing holdings of longer-term issues.

In an address before the Iowa Bankers Association in February, Frank J. Rathje, president of the American Bankers Association, urged every bank to be certain that its financial structure is arranged to make the adjustments required by these developments, and suggested:

> A useful standard for guidance is that the Treasury war loan deposit accounts and the anticipated shift of ordinary commercial deposits should be covered by short-term government securities. Since the total Treasury war loan account will be reduced to approximately 10 per cent of its January 1946 level by July 1947, it would be prudent to cover this liability by an equivalent amount of short-term government securities which can be converted into cash as instalments on the war loan account are called for payment.

The Dilemma of Present Interest Rate Policy

In interpreting recent developments, it must be borne in mind that the problem now faced is altogether different from that which had to be dealt with during the war. At that time the primary task was the marketing of the huge volume of securities needed to finance the war, with its $100 billion budgets. Now the primary problem is credit control and the prevention of inflation. Both the Treasury and the Federal Reserve face the dilemma of wanting to keep interest rates low in order to hold down the cost of the debt and at the same time avoiding encouragement of inflationary expansion.

This is a very difficult dilemma and one that the country has never quite faced before, because it has been willing in the past to accept an upward movement of interest rates in curbing inflation. Clearly, if there has to be a

choice, the essential thing for the country's welfare is that inflation be checked even if it should mean a slightly higher interest cost.

Industrial Corporation Earnings

Annual reports for the year 1945 issued to date by 745 leading manufacturing corporations show combined net income after taxes of approximately $1,153 million, compared with $1,173 million for the same companies in 1944, a decrease of 2 per cent. The number showing increases and decreases was about evenly divided.

In contrast with the slight decrease in the full year, separate figures for the December quarter available from representative companies show a decrease of 27 per cent. Earnings reports for the full year, including fiscal years ended prior to December 31, obscure the unfavorable results during the transition period of the past few months, when net operating incomes were badly squeezed or changed into operating deficits by the falling off in sales volume, rising labor and other costs, OPA ceilings on selling prices, and strikes.

Total capital and surplus of the group at the beginning of 1945 was $13,470 million, upon which the year's net income represented an average return of 8.6 per cent, compared with a 1944 net worth of $13,036 million and a return of 9.0 per cent. The 1945 return continued the downtrend that has prevailed since 1941, when the rate shown by our similar tabulation was 12.4 per cent, and closely approximated the 8.5 per cent shown in 1939. Aggregate sales of the companies giving sales figures last year showed a decline of 7 per cent from the peak reached in 1944.

Because of the combination, unique in our industrial history, of wartime, reconversion, and postwar operations, the income statements of many companies for 1945 are affected by accounting adjustments of sizeable amounts which make difficult a determination of actual operating earnings and impair the comparability with prior years. Some of these special end-of-war transactions represent charges against income and some credits to income, while others are carried directly to surplus account. In addition, many statements are still subject to renegotiation, settlement of war contracts, and further reconversion expense, against which the reserves set up on the books may or may not prove adequate.

The accompanying preliminary summary shows by major industrial groups the comparative earnings of the past two years, together with net worth and annual rate of return. A more complete and detailed summary in our April issue will include several hundred additional manufacturing companies whose reports are published during March, as well as those in the fields of transportation, public utilities, trade, service, and finance.

An examination of the summary will show the highly uneven trend of earnings last year

PRELIMINARY SUMMARY OF MANUFACTURING EARNINGS IN 1944 AND 1945

Net Income is Shown after Depreciation, Interest, Taxes, and Other Charges and Reserves, but before Dividends.—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income After Taxes 1944	Net Income After Taxes 1945	Per Cent Change	Net Worth, Jan. 1 1944	Net Worth, Jan. 1 1945	% Return 1944	% Return 1945
17	Baking	$ 23,697	$ 25,305	+ 6.8	$ 263,290	$ 254,079	9.0	10.0
14	Meat packing	46,236	34,307	—25.8	602,225	632,797	7.7	5.4
59	Other food products	84,244	77,491	— 8.0	757,915	784,757	11.1	9.9
34	Beverages	56,277	71,616	+27.3	369,000	398,353	15.3	18.0
12	Tobacco products	60,568	61,984	+ 2.3	658,293	665,173	9.2	9.3
35	Cotton goods	16,690	18,643	+11.7	218,663	224,682	7.6	8.3
45	Other textile products	37,112	44,837	+20.8	403,792	428,925	9.2	10.5
21	Leather and shoes	16,695	16,291	— 2.4	217,419	218,815	7.7	7.4
16	Rubber products	64,128	61,433	— 4.2	543,464	566,202	11.8	10.9
29	Pulp and paper products	27,171	25,959	— 4.5	352,751	370,153	7.7	7.0
32	Chemical products	162,402	156,845	— 3.4	1,505,860	1,564,828	10.8	10.0
9	Drugs, soap, etc.	30,871	31,261	+ 1.3	226,648	242,470	13.6	12.9
10	Paint and varnish	8,723	10,249	+17.5	118,334	121,722	7.4	8.4
16	Petroleum products	79,046	70,816	—10.4	789,640	835,663	10.0	8.5
20	Cement, glass, stone products	22,353	23,857	+ 6.7	332,327	327,701	6.7	7.3
25	Iron and steel	161,417	156,418	— 3.1	3,142,152	3,175,441	5.1	4.9
10	Agricultural implements	26,587	23,104	—13.1	264,411	286,396	10.1	8.1
23	Electrical equipment	24,323	21,730	—10.7	156,942	167,825	15.5	12.9
66	Machinery	40,112	37,621	— 6.2	315,292	332,819	12.7	11.3
105	Other metal products	84,873	79,621	— 6.2	819,730	842,697	10.4	9.4
62	Transportation equipment	50,999	52,757	+ 3.4	395,334	419,786	12.9	12.6
85	Misc. manufacturing	48,802	51,264	+ 5.0	582,437	608,840	8.4	8.4
745	Total manufacturing	$1,173,326	$1,153,409	— 1.7	$13,035,919	$13,470,124	9.0	8.6

among different industrial groups. Still greater differences of individual companies within the groups are minimized by the group averages.

Effects of War-End Adjustments

While special adjustments are most frequently encountered in companies having reconversion problems, and in many cases neutralize one another in the composite tabulation, they nevertheless should be clearly understood. Some of these transactions, particularly the tax refunds or credits, have been misrepresented as constituting concealed profits and unjustified claims upon the Treasury, and a good deal of misunderstanding is in evidence.

Of the variety of special adjustments, the following are important examples:

1. *Unamortized cost of emergency facilities.* In order to bring about the great expansion of industrial capacity needed for war, Congress provided in 1942 that new plant and equipment constructed or purchased by private capital for war production, and certified by the Government as necessary to the war effort, should be subject to amortization charges of 20 per cent annually, over a five-year life, or shorter in the event of the war ending sooner.

President Truman's declaration setting September 30, 1945 as the termination date of such amortization means recomputing the tax returns for former years, increasing the deductions for amortization, decreasing the amount of tax payable (giving rise to a claim for refund), and decreasing the net income after taxes.

Most companies, however, instead of publishing a series of revised statements for prior years, have simply charged the unamortized cost of war facilities against 1945 earnings. This has the effect of depressing such reported earnings, except to the extent that these charge-offs are cushioned by current tax reserves plus prior years' refunds.

2. *Present value of amortized war facilities.* Stemming from the amortization in full of war plants and equipment is the problem of what remaining value, if any, there may be in such properties. If, after the cost of such properties has been written off, it becomes evident that they have a peacetime value, their replacement on the books at their appraised or reasonable value involves a writing up of assets. Since a credit to income account would inflate the current operating earnings, the adjustment is usually made by crediting the write-up to surplus.

3. *Reconversion expenses and losses.* These include a variety of costs incident to the rearrangement of plant and equipment for the production of peacetime goods following the termination of war contracts, as well as special inventory charges, operating losses during the transition, etc.

Where such costs are charged in operating earnings, they tend to reduce or entirely wipe out current earnings. Where, on the other hand, such costs are charged against contingency reserves, they tend to conceal reconversion expense by leaving the operating earnings unaffected.

Moreover, since contingency reserves were not allowable deductions for tax purposes when set up, but become allowable deductions as spent, the outlays for reconversion give rise to tax credits, and thus raise net income after taxes. In extreme cases the effect might be to convert an operating deficit into substantial net income.

4. *Elimination of reserves no longer needed.* In some cases, where reconversion has been completed quickly, and at less cost than had been anticipated and provided for in reserves charged against earnings of prior years, the unused balance might be eliminated by a credit to 1945 earnings. Since a special credit of this sort, however, would distort the 1945 earnings, the adjustment is usually made by direct credit to surplus.

5. *Wartime losses of foreign assets.* Where American corporations have recovered foreign assets previously charged off as losses due to enemy action, and deducted under our revenue law from tax payments of previous years, the tendency seems to be to credit such write-backs to surplus, which avoids distortion of current earnings. Since such recoveries are fully taxable, they involve a tax problem, but detailed regulations and procedures governing these cases have not yet been worked out by the revenue authorities.

6. *Tax reserves adjusted to lower level of earnings.* Where tax reserves were set up on the basis of the rate of earnings during the first and second quarters of last year, the decline in earnings toward the end of the year permitted many companies to carry forward excess tax reserves, thus lowering still further the required taxes charged in the latter part of the year. The effect in such cases was to bolster reported net income, particularly in the December quarter, and thus partly conceal unfavorable operating results.

Tax Carry-backs

7. *Tax carry-back of unused excess profits credits and operating net losses.* This provision of the tax law has been widely misunderstood, and has been attacked during current labor controversies as affording a "guarantee" of corporate profits. Actually this provision was adopted during the war in lieu of permitting

corporations to set aside postwar or contingency reserves, deductible in computing taxes, to take care of the reconversion expenses which were generally recognized to be a part of general wartime costs, though not determinable until the war was over.

Under this provision, corporations experiencing a decline in net income are permitted to "carry-back" any unused excess profits tax credits against excess profits taxes paid in the two prior years. A net operating deficit may be carried back two years against normal and surtaxes as well as against excess profits taxes. These two provisions have the effect of averaging or equalizing the taxes relative to real earnings over a period of years by refunding any overpayment of taxes after all expenses and losses of the war period become known.

The need for provisions of this sort to give support to business and employment at the end of the war was explained by Randolph E. Paul, General Counsel for the Treasury at the time these measures were under consideration, as follows:

> It is generally accepted that two factors in the wartime situations will accentuate the postwar cash problem. In the first place, the demand for high levels of wartime production has, in many instances, tied up working capital in inventories and work in process. Unless the provisions permitting the carry-back of losses and unused excess profits credit, and the refund of wartime taxes, can be made to operate speedily, and unless the working capital tied up in government contracts can be liquidated promptly, the ability of many firms to survive the transition period may be impaired.

Similar relief was granted after World War I, when the revenue law provided that a net loss in 1919 could be carried back and deducted from net income of 1918, permitting a redetermination of 1918 taxes and a tax refund or credit. Even if no net loss occurred in 1919, claims for abatement of 1918 taxes could be based upon revaluation of inventories, with reasonable allowance for manufacturing and distributing expenses, where actual selling prices in 1919 declined below inventory values at the end of 1918.

As to the charge by Philip Murray, president of the C.I.O. and the United Steelworkers, in a letter to Secretary Vinson, that the carry-back provisions were "secretly slipped through Congress" and "not discussed or analyzed in committee reports or on the floor", it may be pointed out that these measures were clearly explained in the published report of the Senate Finance Committee on the 1942 tax bill at the time this measure was under consideration. In due course the bill was debated by the Senate, sent to conference, then returned to the House and to the Senate for further debate before final passage.

In the hearings the following year on the 1943 revenue bill raising the excess profits tax rate from 90 to 95 per cent, Mr. Murray's statements before the House and Senate tax committees contained no word of criticism of the carry-back provisions enacted the year before.

Mr. Murray charged that "American industry is guaranteed that if any particular company either breaks even or loses money it will receive refunds that may result in larger net profits than the particular company averaged in the prewar years." Citing United States Steel Corporation as an example, he asserted that if it should "break even" in 1946, it could recover $67,340,000 from the Treasury though its average net profit after taxes for the prewar era was $44,732,000. This assertion, however, ignores the fact that the Steel Corporation paid no excess profits tax in either 1944 or 1945, and so on a break-even basis could receive no refund whatever in 1946.

The provision for carry-back of unused excess profits tax credits is unlikely to relieve the "giant industrial corporations" mentioned in Mr. Murray's letter to nearly as great an extent as the smaller industrial corporations. This is because the wartime earnings of most of the larger corporations followed a stable or downward trend, whereas earnings of the smaller manufacturing concerns, including marginal producers, rose rapidly as their facilities were brought into capacity operations by the huge war demands. This divergence in earnings trends is shown clearly in the Treasury "Statistics of Income" and in studies by the Federal Reserve Board and by Dun & Bradstreet. Since the earnings of the smaller companies rose more rapidly, but might also decline more rapidly in times of business recession, they naturally stand to benefit most by spreading the computation of taxes over a longer period.

Postwar Refunds of Excess Profits Taxes

Entirely separate from these various accounting and tax adjustments affecting the current income statement is the postwar refund of excess profits taxes. In the Revenue Act of 1942, which raised the excess profits tax from a graduated rate of 35-60 per cent to a flat 90 per cent (95 per cent in 1943-45), there was provision for a 10 per cent refund, to be represented by a special issue of Treasury bonds, non-interest-bearing, non-negotiable, and maturing at stated intervals after the end of the war. Such bonds are in the nature of a forced loan to the Government and, according to law, "the proceeds received upon redemption are not to constitute taxable income of the bondholder."

In the Tax Adjustment Act of 1945, Congress amended the provision as to maturity of such bonds by making them payable at the option of the owner after January 1, 1946, and provided also that the postwar refund for which bonds had not already been issued should be

made currently available for tax liabilities of 1944 and subsequent years.

In accordance with these amendments, designed to return promptly to business the cash needed for meeting the expenses and losses of reconversion, the Treasury has redeemed since January 1st about $950 million of such outstanding bonds, while corporations have since September 1945 taken current credit for refunds against their quarterly income taxes payable. Such refunds or credits a.e not "gifts", but repayments of the forced loan earmarked for postwar use.

Significance of Net Income Figures

In our tabulations of published reports, the "net income after taxes" is compiled as reported, reflecting the judgment of the corporation accountants and management in each particular case. No attempt has been made to recast the income statements, either by eliminating special charges or credits made directly to income account, or by introducing other items that were carried directly to surplus. In cases where prior years have been restated in company reports for comparative purposes, however, the revised figures are used.

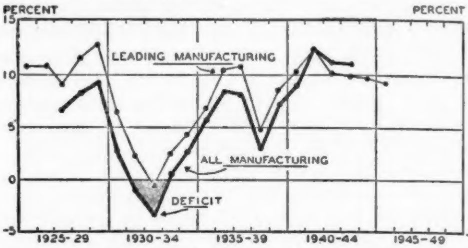
The special accounting adjustments necessitated by the war have been given a great deal of time and study by the public accounting profession. The American Institute of Accountants has issued a series of "Accounting Research Bulletins," prepared by its Committee on Accounting Procedure, some of which deal in a comprehensive way with various important phases of the subject, and numerous articles have appeared in its monthly "Journal of Accountancy".

While these special adjustments cannot be treated uniformly or according to hard and fast rules, the general aims have been, first, to give full disclosure of such special items (if material) in order that an examination of the reports will reveal their effects upon the income statement and balance sheet and, second, to show the "net income" in such way that it will be as significant as possible in measuring the year's actual earnings.

Finally, because of the impossibility during the war and the "clean-up" period afterward of making precise annual allocations of operating results by many companies engaged in all-out war production, an accurate measure of real earnings can be obtained only by comparison and reconcilement of a series of statements covering several years.

Long-Term Earnings Trend

The course of manufacturing corporation earnings over the longer term is indicated by the accompanying chart, which shows the annual percentage of net income after taxes to net worth of all manufacturing corporations in the United States, based upon the Treasury Department "Statistics of Income," and of leading manufacturing corporations, based upon our own annual tabulations of published shareholders' reports.



Annual Rate of Return on Net Worth of All Mfg. Corp. and of Leading Mfg. Corp.

Average rates for leading corporations, from National City Bank annual tabulations of published shareholders' reports were:

1925	10.7	1929	12.8	1933	2.5	1937	10.8	1941	12.4
1926	10.8	1930	6.4	1934	4.3	1938	4.8	1942	10.1
1927	9.0	1931	2.3	1935	6.7	1939	8.5	1943	9.9
1928	11.6	1932	-0.5	1936	10.4	1940	10.3	1944	9.8

1945 (preliminary) 8.6

Data for all corporations appear in the table following.

The official Treasury statistics cover some 84,000 manufacturing corporations, and preliminary figures for 1943 have just been issued. The high level of return shown for 1941-43 relative to the rates of leading corporations reflects the greater improvement in earnings, or elimination of deficits, of large numbers of closely-held, medium and small concerns which do not issue public figures. Another difference between the two series reflects the fact that

All Manufacturing Corporations in the U. S.

(In Millions of Dollars)

Year	Gross Income a	Fed. Inc. & E.P. Taxes	Net Inc. Aft. Tax-a	Net to Gross Inc. %	Net Dividends Pd.-a	Net Worth Jan. 1st	Net. Inc. Aft. Tax-b	Rate of Return %
1926	$62,156	$ 585	$3,212	5.2	$2,116	$ (c)	$ 3,640	(c)
1927	63,439	508	2,673	4.2	2,226	46,273	3,050	6.6
1928	66,893	545	3,460	5.2	2,507	48,050	3,935	8.2
1929	71,640	544	3,954	5.5	2,575	50,017	4,537	9.1
1930	60,428	317	877	1.5	2,613	52,695	1,424	2.7
1931	43,716	165	- 913	-2.1	1,894	52,122	- 521	-1.0
1932	31,845	100	-1,827	-5.7	1,115	47,640	-1,616	-3.4
1933	35,070	207	77	0.2	1,010	43,976	237	0.5
1934	40,768	266	778	1.9	1,221	43,342	1,166	2.7
1935	47,334	357	1,508	3.2	1,580	38,152	2,122	5.6
1936	56,431	608	2,570	4.6	2,321	37,611	3,116	8.3
1937	61,950	652	2,545	4.1	2,429	38,467	3,069	8.0
1938	50,824	377	909	1.8	1,344	41,239	1,228	3.0
1939	57,939	634	2,579	4.5	1,843	41,260	2,946	7.1
1940	66,618	1,553	3,391	5.1	2,027	42,439	3,764	8.9
1941	92,940	4,946	4,991	5.4	2,333	44,163	5,493	12.5
1942p	119,136	8,228	5,126	4.3	2,206	48,398	5,432	11.2
1943p	145,941	10,527	5,728	3.9	2,318	55,071	6,040	11.0

Source: Compiled from Treasury Department annual "Statistics of Income". a- Excludes intercorporate dividends. b- Includes intercorporate dividends. c- Complete figures not available. p- Preliminary. – Deficit.

Treasury statistics show statutory net income as defined for tax purposes, which makes no allowance for charges against income for con-

tingency and postwar reserves, since these are not allowable deductions from operating income in computing taxes; this causes net income to be higher than when such reserves are deducted as in the generally accepted procedure for published statements.

The accompanying condensed summary of Treasury figures shows the enormous wartime expansion in gross income from sales and other sources through 1943 (which continued through 1944), and the resulting substantial rise in net income, despite the many-fold increase in federal taxes. The increase in dividends was relatively small, with net payments below those of the late 1920s when volume of business was much smaller.

For the eighteen-year period 1926-43, net income (excluding intercorporate dividends) after taxes of all manufacturing corporations in the United States averaged annually but 2.9 per cent of total sales volume, and dividends paid out averaged but 3.2 per cent of sales. The annual rate of net income after taxes to net worth (including both intercorporate dividends and intercorporate stock holdings) for the period 1927-43 averaged 5.9 per cent. This compares with an average shown by our tabulations of leading companies for the years 1925-45 of 8.2 per cent.

1945 Balance Sheet Changes

A composite balance sheet of 120 manufacturing corporations having annual sales or total assets over $5 million is given in the accompanying table and shows the reversal during 1945 of some but not all of the trends that had prevailed during the years of wartime expansion following 1940.

The substantial expansion of total assets of the group that took place during each of the years 1941-44 came to an end in 1945. The rise in inventories was accounted for principally by the tobacco companies. Both cash and government securities were down slightly, and there was a sharp liquidation of receivables, reflecting settlement of war contracts.

Additions to property account last year were more than offset by depreciation charges, and at the year-end the reserves for depreciation amounted to 59 per cent of gross plant and equipment, compared with 46 per cent in 1940. The decrease in "other assets", which in prior years included the statutory refund of excess profits taxes, reflected the 1945 tax amendments referred to above which made such refunds currently available, permitting either

Composite Balance Sheet of 120 Manufacturing Companies with Sales or Total Assets over $5 Million

(In Millions of Dollars)

	December 31			
Assets	1940	1943	1944	1945
Cash	$ 384	$ 533	$ 547	$ 529
Government securities†	46	509	555	538
Receivables, net	349	619	631	511
Inventories*	1,102	1,689	1,736	1,860
Total current assets	1,881	3,350	3,469	3,438
Land, plant & equipment	2,318	2,442	2,535	2,529
Less depreciation	1,073	1,236	1,317	1,483
Net property	1,245	1,206	1,218	1,046
Other assets	324	362	393	371
Total assets	3,450	4,918	5,080	4,855
Liabilities & Capital				
Notes payable	70	131	206	218
A/c pay., accruals, etc.*	216	510	502	384
Reserve for taxes†	172	777	729	537
Total current liab.	458	1,418	1,437	1,139
Deferred liabilities	320	465	527	466
Reserves	88	161	173	170
Capital and surplus	2,584	2,874	2,943	3,080
Total	3,450	4,918	5,080	4,855
Working capital	1,423	1,932	2,032	2,299
Current ratio	4.11	2.36	2.41	3.02

†Before deducting tax notes offset against taxes payable. * Includes advances on government contracts.

the transfer of refund bonds from a "slow" to a "current" status along with other government securities, or the deduction of refunds from the reserve for taxes payable.

The latter shows the largest decrease of any of the liability items, although there was a substantial liquidation also in the total of accounts payable, accruals, and miscellaneous current liabilities. The decrease in deferred liabilities was caused mainly by repayment of term loans of war materials manufacturers. The decrease in current liabilities brought about further improvement in liquidity, measured both by net current assets and by the "current ratio".

Although this composite balance sheet shows the changes of an important group of large companies, it comprises but a small sample of the total manufacturing industry. Large numbers of medium and small size corporations have built up their net worth and working capital much more rapidly during the war period, while others have had their liquidity impaired by overexpansion, shortage of manpower and materials, squeezing of profit margins, and other unfavorable factors.

Painting by Karl Godwin—"Llama herding in Peru"

Peru's Llama Makes U. S. Jobs

TO READERS of any popular dictionary the llama may be only "a South-American woolly-haired cameloid ruminant without a hump," but for American exporters of mining machinery, office appliances and motor cars to Peru, this animal is a creator of foreign exchange. Alpaca wool is among Peru's exports to the U. S. Others include copper, zinc, lead, vanadium ores and guano.

Manufacturing is developing in Peru, and far more are employed now in industries than the prewar 400,000. The textile industry is the oldest. Next in importance are clothing, furniture, chemicals, drugs, cement and paper. During the war about 1,200 new enterprises were established.

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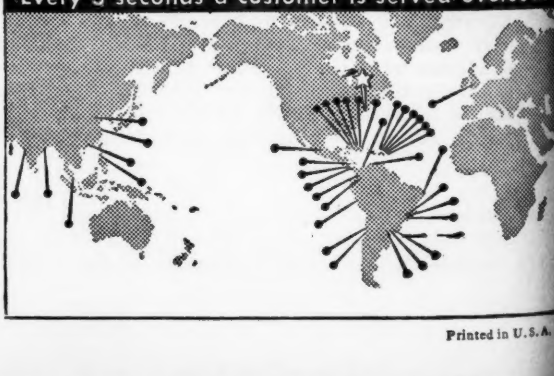

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